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Highlights

Highlights of GAO-13-158, a report to congressional requesters

January 2013

PENSION COSTS ON DOD CONTRACTS

Additional Guidance Needed to Ensure Costs Are Consistent and Reasonable

Why GAO Did This Study

DOD contractors are among the largest sponsors of defined benefit pension plans in the United States and factor pension costs into the price of DOD contracts. Since the 2008 market downturn, these pension costs have grown—thereby increasing DOD contract costs—and recent changes in rules for calculating pension costs have raised the prospect of further cost increases. Given this possibility, GAO assessed how (1) contractor pension costs are determined; (2) DOD ensures the contractor pension costs it pays are appropriate; (3) DOD contractors' defined benefit pension plans compare with plans sponsored by similar companies; (4) pension costs have affected DOD contract costs and the factors that contributed to these pension costs; and (5) the harmonization of CAS with ERISA will affect the amounts DOD will pay in pension costs in coming years. To do this, GAO analyzed defined benefit pension plans for the largest contractors; interviewed contractor and DOD officials; and reviewed relevant laws and regulations, including changes made to harmonize CAS with ERISA.

What GAO Recommends

GAO recommends that the Secretary of Defense clarify responsibility for and guidance on assessing pension reasonableness and determining discount rates for pension cost projections. GAO recommends that the CAS Board set a schedule for revising the parts of CAS that address the settlement of plan curtailments. DOD agreed with the recommendations to the Secretary of Defense, and OMB said that when the CAS Board meets it will consider a schedule for revision.

View GAO-13-158. For more information, contact Cristina Chaplain at (202) 512-4841 or chaplainc@gao.gov; or Charles Jeszeck at (202) 512-7215 or jeszeckc@gao.gov.

What GAO Found

Labor costs are included in the prices contractors negotiate with the Department of Defense (DOD), and include pension costs as these are a normal element of employee compensation. Contractors make two sets of calculations for their defined benefit pension plans, following two sets of standards: (1) Cost Accounting Standards (CAS), which determine how pension costs are allocated to government contracts; and (2) Employee Retirement Income Security Act of 1974 (ERISA), which establishes the minimum contribution required to fund plans. In 2008, revised ERISA rules altered the minimum funding requirements, causing CAS costs and ERISA contributions to diverge further apart. ERISA contributions have therefore greatly exceeded CAS pension costs reflected in contract prices. In December 2011, almost 4 years after ERISA changes took effect, the CAS Board, which is part of the Office of Management and Budget (OMB), made changes to CAS that harmonized them to ERISA in order to gradually reduce the difference between the two calculation methods.

DOD centralizes its technical expertise for management and oversight of defined benefit pension plans. DOD contracting officers at the corporate level negotiate pension costs with contractors and receive technical support from a team of DOD actuaries. DOD audits projected and actual costs for contracts, including pension costs, to ensure they are allowable, allocable, and reasonable. The Federal Acquisition Regulation requires that employee compensation, including pensions, be reasonable. However, the pension costs used for compensation reviews can be affected not only by the value of benefits earned by employees, but also by factors such as asset returns and interest rates. Also, oversight processes do not clearly assign responsibility for assessing the reasonableness of pension benefits, including those for executives.

GAO analyzed the defined benefit plans of the 10 largest DOD contractors and found that nearly all of the contractors—as well as a peer group of companies—maintain some sort of tax-qualified, defined benefit plan for their employees. The largest contractors invest in similar types of pension plan assets as their peer group, and do so somewhat more conservatively. GAO also found that CAS pension costs reported by the contractors grew considerably over the last decade, from less than $500 million in 2002 to almost $5 billion in 2011, although not all of these costs were allocated to DOD contracts. Contractor CAS pension costs grew as the market downturn increased unfunded liabilities.

Although pension cost projections are highly sensitive to economic assumptions, both contractors and DOD officials expect CAS pension costs to increase starting in 2014 due to harmonization. The CAS discount rates used to value liabilities will now be tied to the more volatile ERISA-based rates, making it harder to forecast future CAS pension costs and reducing the consistency of cost projections used in contract pricing. DOD issued limited guidance on projecting ERISA-based discount rates for CAS calculations, but lack of specificity in the guidance can lead to great variation among the rates contractors use. Moreover, when a contractor curtails a plan, DOD and the contractor must settle pension costs; however, the discount rates used for settlements were not updated as part of harmonization, meaning liabilities will be calculated differently under CAS and ERISA rules. A schedule has not been set for addressing this issue.